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No. 00-157

IN THE

# Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC.,

*Petitioner,*

*v.*

UNITED STATES OF AMERICA,

*Respondent.*

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

## REPLY BRIEF

ERIC R. FOX
*Counsel of Record*
ALAN J.J. SWIRSKI
IVINS, PHILLIPS & BARKER
*Attorneys for Petitioner*
1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 393-7600

165822

Counsel Press LLC
(800) 274-3321 • (800) 359-6859

## CORPORATE DISCLOSURE STATEMENT

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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## ARGUMENT

### A. The Deduction Of Product Liability Expenses In The Computation Of The Positive Separate Taxable Income Of A Member Of An Affiliated Group Does Not Preclude Those Expenses From Being Taken Into Consideration In Computing The Affiliated Group's Product Liability Loss.

Respondent's primary argument rests on a single, flawed premise. According to respondent, any product liability expenses of a member of an affiliated group with positive separate taxable income are somehow "consumed" or used up in the computation of that income, and no longer exist to be taken into consideration in computing the group's product liability loss. (Res. Br. 16-24, 27-28, 33-34.) The Sixth Circuit flatly and persuasively rejected this argument in *Intermet Corp. v. Commissioner,* 209 F.3d 901, 906-907 (6th Cir. 2000) (Pet. App. E at 71a):

> While we agree with the IRS's overall description of the consolidated return regulations, we reject its analysis. A member's STI [separate taxable income] is simply a step along the way to calculating the group's taxable income or CNOL [consolidated net operating loss]. An STI has no other purpose. More to the point, the regulations prescribing the calculation of STI and CNOL do not govern the determination of CNOL carrybacks. That issue is governed by Treas. Reg. § 1.1502-21A(b), which applies the principles of section 172 to the consolidated NOL of the group, rather than separate member "NOL's" or STIs, in situations such as this one, which do not involve separate return years. In addition, the IRS and the Tax Court perceive a distinction between positive

> and negative STI that is unsupported by the regulations. An STI's character as positive or negative has no independent significance — either for purposes of calculating CNOL or otherwise. A member's SL [specified liability] expenses[1] affect the group's CNOL dollar-for-dollar, and it makes no difference whether the member has a positive or negative STI. Because neither the purpose nor the language of the consolidated return regulations provide a basis for concluding that the member's SL expenses are "exhausted" when the member has a positive STI but remain when the member has a negative STI, we find that the IRS's interpretation is unreasonable.

Contrary to respondent's assertion, after the product liability deductions of a member of an affiliated group with positive separate taxable income are used mathematically to offset income of that member in arriving at the amount of its separate taxable income, using that member's product liability deductions in the comparison of the group's total product liability deductions with its consolidated net operating loss is both permissible and appropriate.

Without question, the amount of the product liability deductions in issue had a direct effect on the amount of the AMCA group's consolidated net operating losses for the years in which such losses arose, and were taken into consideration in determining the amount of those losses regardless of the fact that this was accomplished in a two-step process of (1) determining separate taxable income, followed by (2) determining consolidated taxable income. Respondent's "consumed" argument therefore should be rejected. *See* Lawrence M. Axelrod and Jeremy B. Blank,

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1. Specified liability expenses in *Intermet* are the exact equivalent of product liability expenses in this case.

*The Supreme Court, Consolidated Returns, and 10-Year Carrybacks*, 90 Tax Notes, Number 10, 1383, 1394 (hereinafter "Axelrod").

**B. There Is No Double Deduction.**

The Court understandably would not want to be in the position of sanctioning a rule that provides taxpayers with double deductions. In an attempt to bolster the flawed argument discussed above, respondent claims that petitioner will secure a double deduction if its position in this case is sustained. (Res. Br. 16, 29.) This is a demonstrably false contention.

Assume an affiliated group consisting of two corporations, A and B. A has positive separate taxable income of 100 after having taken into consideration product liability deductions of 200. B has negative taxable income of 500, having had no product liability deductions. The group unquestionably has a consolidated net operating loss of 400 which can be carried to some other year.

In this example, the first thing to note is that the net operating loss of 400 produces no tax benefit until it is applied to reduce income in another year. In and of itself, it creates no tax benefit; it is simply a loss. Bearing that fact in mind, assume that A's product liability deductions of 200 had not existed. In that case its separate taxable income would have been 300 and the consolidated net operating loss of the group would have been reduced to 200. As in the case of the 400 loss, the affiliated group pays no income tax for the year in which the loss arises, and the 200 loss creates no tax benefit until it is applied against income in another year.

Thus, whether or not the affiliated group in this example has a deductible product liability expense of 200 in the first

instance, that deduction produces no benefit unless and until the group's consolidated net operating loss reduces the group's income in some other year. Only at that time will the group receive a single tax benefit for its product liability expenses. *Intermet v. Commissioner*, 209 F.3d 901, 908 (6th Cir. 2000). (Pet. App. E at 75a.)

The pivotal point is that, if respondent prevails, the AMCA group will be entitled to the identical consolidated net operating loss carryover it will be entitled to if petitioner prevails. The only thing that changes is the year to which a portion of that loss can be carried to offset other income. It is preposterous to claim that, if AMCA obtains a tax benefit by deducting its consolidated net operating loss against the income of a year that would satisfy the respondent, it does not obtain a double deduction of any product liability expenses while, at the same time, contending that a deduction of that same loss against the income of a different year yields a second deduction of those same product liability expenses.

There is only one deduction of the product liability expenses in either case. The parties are simply at odds as to the year in which AMCA is entitled to claim the deduction, and they are at odds in this regard solely because of a combination of tax rate changes and the time value of money, not because the petitioner is attempting to claim the same deductible item twice. If it were not for the noted tax rate changes and time value of money considerations, this case would not exist. *This case involves only the issue of when a taxpayer can claim a deduction; it has absolutely nothing to do with whether the taxpayer is entitled to the deduction in the first instance.* Axelrod at 1394.

### C. The AMCA Affiliated Group Is Properly Regarded As The Taxpayer For The Purpose Of Applying Section 172(j)(1).

In its Brief, petitioner explained why the AMCA group should be treated as a single taxpayer for purposes of applying section 172(j)(1) (Pet. Br. 25-27), as held by the Sixth Circuit Court of Appeals in the *Intermet* case (Pet. App. E at 74a). In opposition to this contention, respondent cites *Woolford Realty Co. v. Rose*, 286 U.S. 319 (1932),[2] a case that is readily distinguishable. (Res. Br. 11-12, 30-31.)

*Woolford Realty* involved Woolford Realty's acquisition of Piedmont Savings Co. in 1927. The two corporations filed a consolidated federal income tax return for that year under § 240 of the Revenue Act of 1926. Prior to the merger, Piedmont had incurred losses in 1925 and 1926 which it attempted to carry over to the affiliated group's 1927 consolidated return. Piedmont had a loss in 1927 as well as in 1925 and 1926. At the time, the consolidated return regulations contained no provision comparable to Treas. Reg. § 1.1502-21(c), addressing the carryover of losses from what came to be called a separate return year to a consolidated return year. That regulation limits such carryovers to the amount of income generated during the consolidated return year by the group member that incurred the loss in the separate return year, the rule adopted in *Woolford Realty*.

To reach that result, the Court decided that, absent any factor indicating a contrary result, the rules applicable to

2. Respondent also cites *Helvering v. Morgan's, Inc.*, 293 U.S. 121, 127 (1934), and *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 440 (1943). (Res. Br. 38.) Petitioner's argument with respect to *Woolford Realty* applies with equal force to *Helvering v. Morgan's*. *Moline Properties* is miscited because it has nothing to do with affiliated corporations, as that term is used in this case.

the carryover of net operating losses from separate return years to consolidated return years had to be analyzed on a separate company basis. In support of its position, the Court stated that a corporate member of an affiliated group does not cease to be a taxpayer by the fact of affiliation. 286 U.S. at 328.

Relying on this statement, respondent contends that the AMCA affiliated group cannot be viewed as a single taxpayer. This argument does not withstand scrutiny. First, the Court's conclusion that each member of an affiliated group remains a separate taxpayer properly should be viewed as *dictum*. The statement was unnecessary to the Court's decision which was already established by the Court's conclusion that there was no statutory or regulatory support for Woolford Realty's position.

Second, while the Court in *Woolford Realty* held that the members of the group had to be treated as separate entities for the purpose of establishing a rule for the carryover of net operating losses from a separate return year to a consolidated return year, it never held that members of an affiliated group must be treated as separate taxpayers for all purposes. The Internal Revenue Service clearly has never read *Woolford Realty* to stand for such a proposition, as is evidenced by the many examples provided both in petitioner's Brief (26-27) and the Brief of the *Amici Curiae* (6-7), in which the Internal Revenue Service has treated an affiliated group as a single taxpayer.

Even prior to the *Woolford Realty* decision, the Internal Revenue Service had promulgated a regulation on January 3, 1929, also dealing with the carryover of net operating losses by affiliated groups of corporations filing consolidated income tax returns, in which the Service provided that, under certain conditions, a carryover of a net operating loss by an

affiliated group was to be determined "in the same manner, to the same extent, and upon the same conditions as if such group were a single corporation and the same taxpayer. . . ." Regulations, 75, Art. 41(b) (1929). This regulation was upheld in *S. Slater & Sons, Inc. v. White*, 119 F.2d 839 (1st Cir. 1941), in which *Woolford Realty* was considered in detail.

The First Circuit rejected the taxpayer's argument that *Woolford Realty* precluded treating an affiliated group as a single taxpayer, noting that a new revenue act had been enacted, new income tax regulations had been issued and, most tellingly, when *Woolford Realty* "applied a consistent separate-taxpayer theory for purposes of the two-year carry-over, there was no occasion to compute a 'consolidated net loss' as we have above indicated." *Id.* at 845. The court added that "[t]he single-taxpayer theory has the merit of simplicity, and it also conforms to business reality." *Id.* at 843.

In short, although the separate taxpayer approach made perfect sense in *Woolford Realty,* the Court certainly never indicated that this approach was to have universal application in all consolidated return situations regardless of the specific issue involved. Notwithstanding *Woolford Realty*, the Internal Revenue Service has never expressed a belief that there is a universal rule requiring every member of an affiliated group to be treated as a separate taxpayer for all consolidated return purposes. Admittedly, there are situations when this is appropriate, typically when carrying losses from separate return years to consolidated return years or from consolidated return years to separate return years. In the overwhelming number of situations involving tax consequences that remain wholly within the affiliated group, however, the Internal Revenue Service has chosen to treat an affiliated group as a single taxpayer, a treatment clearly envisioned by Congress.

When consolidated returns were first permanently introduced into the tax law by section 240 of the Revenue Act of 1919[3], the Senate Committee on Finance, then considering the Revenue Bill of 1918, stated:

> While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its effect upon the revenue, but *because the principle of taxing as a business unit what in reality is a business unit is sound and equitable* and convenient both to the taxpayer and to the Government.

S. Rep. No. 617, 65th Cong. 3d Sess. (1918); 1939-1 C.B. (Part 2) 117, 123 (emphasis added).

When the Revenue Act of 1928 was under consideration, a proposal was made by the House of Representatives to eliminate consolidated income tax returns. The Senate Committee on Finance rejected this notion, stating:

> Inasmuch as there is apparently some misunderstanding as to the effect of the House bill and as to what consolidated returns really are, it seems advisable at this time to discuss the subject somewhat at length.
>
> After the enactment of the profits tax of 1917, a committee, consisting of members of the Committee on Ways and Means of the House, of the Committee on Finance of the Senate, and of

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3. Consolidation had been authorized on a trial basis by the Revenue Act of 1917.

leading experts, was engaged in the preparation of regulations to carry out the Act. As a result of a very careful and nonpartisan consideration of the subject by this committee, the Treasury authorized the filing of consolidated returns by corporations which, by reason of common ownership, were affiliated — that is, although composed of several corporate entities, were as a practical matter but one corporation. . . .

* * *

The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every one of its agencies. It would be just as unreasonable

> to demand that an individual engaged in two or more businesses treat each business separately for tax purposes.

S. Rep. No. 960, 70th Cong., 1st. Sess., at 13-14 (1928); 1939-1 C.B. (Part 2) 409, 417-418.

### D. The *Amtel* Case Did Not Address The Issue In This Case.

Respondent erroneously cites *Amtel, Inc. v. United States*, 31 Fed. Cl. 598 (1994), *aff'd without opinion*, 58 F.3d 181 (Fed. Cir. 1995), as supporting its position. (Res. Br. 6-7, 24-25.) That case never addressed the question presented to this Court. *Amtel* asked whether a member of an affiliated group with positive separate taxable income earned in a year in which the affiliated group of which it was a member had a consolidated net operating loss could, by using the 10-year carryback rule, carry back to a *separate return year* (*i.e.*, a year in which the member with the positive separate taxable income was not a member of the consolidated group and filed a separate tax return) a portion of the affiliated group's net operating loss as a product liability loss. By contrast, the current case asks whether an affiliated group can carry back a product liability loss *to one of its own consolidated return years.*

Although both cases involve the carryback treatment of a portion of a consolidated net operating loss when deductions included in the computation of that loss are incurred by a group member with positive separate taxable income, they present completely different issues.

In deciding *Amtel*, the Court of Federal Claims defined the issue before it as whether a member of an affiliated group was entitled to carry back a portion of the group's

consolidated net operating loss to offset income previously reported by that member on a separate return. 31 Fed. Cl. at 599. The only analysis the court required to deny the carryback in issue was that the Treas. Reg. § 1.1502-79(a)(3) formula did not operate any differently with respect to the 10-year carryback rule for losses attributable to product liabilities than it did with respect to consolidated net operating losses in general. *Id.* at 600.

Respondent attempts to leverage its reliance on *Amtel* by arguing that, if the AMCA group could not carry product liability deductions to a separate return year, there is no reason why it should be able to carry them back to a consolidated return year. (Res. Br. 41, n.28.) This contention misses the mark for two reasons.

First, the AMCA group, whether in the context of this case or of *Amtel*, had a fixed consolidated net operating loss in each year in issue. For the taxpayer to have prevailed in *Amtel*, it would have to have demonstrated that, without regard to product liability expenses, some portion of AMCA's net operating loss properly could be carried back to a separate return year. This it could not do. Thus, Amtel was not even entitled to carry any loss back three years, much less 10 years. That result is the sum and substance of what was held in the *Amtel* case. Any language relating to "consolidated product liability deductions," apart from being misdirected for the reasons stated in petitioner's Brief (27-29), was pure *dictum*.

Second, the fact that some members of the AMCA affiliated group were not members of the group for the entire 10-year period in issue, a factor made much of by respondent (Res. Br. 7, n.6, 40-41, n.28), is a red herring. Neither court below ever took this point into consideration in its decision. Further, the United States has never before raised this as an issue (quite properly so) because there is no provision in

either the Internal Revenue Code or the consolidated return regulations to support such a position.

Any time a new member of an affiliated group has a deduction that contributes to the group's consolidated net operating loss, that loss can be carried back to an earlier consolidated return year of the group preceding the affiliation of the new member if that member has positive separate taxable income. Thus, there is absolutely nothing unique about deductions of a new member of an affiliated group being included in the carryback of a consolidated net operating loss to an earlier consolidated return year of the group when the member generating the deductions was not yet a member. Accordingly, the question of whether to apply the section 172, 10-year carryback rule on a group-wide basis, as opposed to a separate company basis, does not turn in any conceivable way upon the fact that a member of the affiliated group with product liability deductions was not a member of the group for the entire 10-year period.

Respondent's contrived hypothetical situation (Res. Br. 40, n.27), designed to worry the Court that a general decision in favor of treating the affiliated group as a single entity for 10-year carryback purposes will open the door to tax abuse, is based on a highly unlikely set of circumstances that assumes the equally unlikely willingness of a corporation to acquire another corporation faced with the prospect of inordinately large liabilities of an unknown magnitude. In any event, there is certainly not a shred of evidence in this case that AMCA acquired affiliates to create 10-year carrybacks.[4]

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4. Significantly, respondent fails to acknowledge section 269 of the Code, which already provides the Service with ample authority to disallow the benefits of any deduction, credit or allowance of any corporation that acquires another for the principal purpose of evading Federal income tax.

## E. In The Absence Of Clear Guidance, Petitioner's Position Represents The Most Appropriate Basis For Deciding This Case.

Neither the Internal Revenue Code nor the consolidated return regulations contain a specific rule that addresses the facts before the Court. Under these circumstances, respondent is asking this Court to sanction a departure from the consolidated net operating loss structure established by the Internal Revenue Service for no other reason than to enrich the fisc.

Respondent attempts to support its position with a resort to the statutory construction doctrine termed *expressio unius est exclusio alterius* or "the expression of one thing is the exclusion of another." Thus, at page 31 of its Brief, respondent notes three instances in which Congress specifically provided for the treatment of an affiliated group as a single taxpayer, and then argues that the failure of Congress to provide the same in connection with section 172(j)(1) must be read as Congressional intent to apply that section to affiliated groups on a company-by-company basis.

This contention fails on two grounds. First, the Court has long noted that the *expressio unius* rule must be applied with great caution. In *Ford v. United States*, 273 U.S. 593, 612 (1927) (quoting *Colquhoun v. Brooks*, L.R. 21 Q.B Div. 52, 65), the Court, speaking of this rule, stated:

> It is often a valuable servant, but a dangerous master to follow in the construction of statutes or documents. The *exclusio* is often the result of inadvertence or accident, and the maxim ought not to be applied, when its application, having regard to the subject-matter to which it is to be applied, leads to inconsistency or injustice.

In an article in the Harvard Law Review, Professor Max Radin of the University of California School of Jurisprudence, addressing the rule, after referring to it as "one of the most fatuously simple of logical fallacies, the 'illicit major,' long the *pons asinorum* of schoolboys," stated:

> It must be clear that the only value which such a maxim or axiom or rule could have would lie in the existence of an infallible or approximately infallible test of its applicability. Emphasis will help us in ordinary speech, but except for such inferred emphasis as the general purpose of the act will enable us to apply, no other stress on the words will be apparent in the printed page. The question will accordingly be in every case, not whether or not the expression of one thing excludes everything else, but whether we are to deny or affirm it for some other reason than its axiomatic force, and it will be necessary to search for that other reason.

*Statutory Interpretation*, 43 Harv. L. Rev. 863, 874 (1930); *see also* Axelrod at 1391-1392.

Second, the *expressio unius* rule is particularly inappropriate in this case because the sections cited by respondent, which include the single taxpayer language, are each provisions designed to deny tax benefits to taxpayers, not to provide them. Section 172(h) was introduced into the Internal Revenue Code to limit the inclusion in net operating losses of a certain type of interest. The rule could have been avoided by affiliated groups if it was not applied on a single entity basis. For instance, section 172(h)(2)(D) provides a $1 million *de minimis* exclusion from the application of the interest disallowance rule for each "taxpayer." If this exclusion were applied on a separate company basis, an affiliated group could create an infinitely expandable exclusion for itself.

The same reasoning applies to section 860E(a), a provision designed to insure that investors in real estate mortgage investment conduits, or REMICs, would report a certain minimum income that could not be reduced by net operating losses. Congress determined that single taxpayer treatment for affiliated groups was necessary to preclude such groups from avoiding the rule in question. H.R. Rep. No. 795, 100th Cong., 2d Sess., at 82 (1988); S. Rep. No. 445, 100th Cong., 2d Sess., at 88 (1988). Section 860J, which is directly tied into section 860E(a), is also a restrictive section easily avoided by affiliated groups if they could treat each group member as a separate taxpayer.

That Congress would want to insure that taxpayers could not easily avoid tax raising provisions by treating the members of an affiliated group as separate taxpayers tells us absolutely nothing about what Congress might have intended with respect to a taxpayer relief provision.

Notwithstanding respondent's contention that petitioner has not carried its burden of proof (Res. Br. 35), petitioner has demonstrated that respondent's approach cannot comply with the requirements of section 172(j)(1). That section plainly requires a comparison of product liability deductions with a net operating loss. No affiliated group member's separate taxable income can equate with a net operating loss until manipulated in some manner through the creation by the courts of some newly-invented approach, not set forth in the consolidated return regulations, a fact fully recognized by the Fourth Circuit. (Pet. App. A at 19a-21a.)

Ultimately, what this Court is faced with is the job of filling a hole left by the Internal Revenue Service. This is not an isolated hole in the landscape, however, but part of a distinctive formation that should be filled in so as to leave it in harmony with its surroundings. In this regard, any

ambiguity should be charged against the creator of the hole, as the Tax Court noted in a case cited with approval by respondent, *Gottesman & Co. v. Commissioner*, 77 T.C. 1149 (1981).

In that case, the consolidated return regulations were unclear as to whether they were to be applied with respect to the accumulated earnings tax rules on a separate company or on a consolidated basis. The Commissioner opportunistically argued for consolidated treatment, but the Tax Court held that, in light of the lack of clarity in the regulations attributable to the Internal Revenue Service, the taxpayer should prevail:

> We cannot fault petitioner for not knowing what the law was in this area when the Commissioner, charged by Congress to announce the law (sec. 1502), never decided what it was himself. Petitioner had no reason to assume that the definition provided in the old regulations applied under the new regulations. In fact, for reasons already stated, petitioner had every reason to assume the opposite.
>
> Thus, we find that the Commissioner's regulations regarding the manner in which the accumulated earnings tax was to be imposed on corporations making consolidated returns were ambiguous during the years at issue. This ambiguity was of the Commissioner's making, and, as such, must be held against him. Petitioner's interpretation of these regulations was reasonable under the circumstances. We think that under these circumstances the failure of petitioner to comply with respondent's post hoc view of the regulations is an insufficient ground on which to

> impose the accumulated earnings tax, and we hold for the petitioner on the issues herein presented.

77 T.C. at 1157-1158 (citation omitted).

This conclusion is consistent with the rule of statutory construction which directs that remedial tax provisions be construed liberally in favor of taxpayers. *Mertens Law of Fed Income Tax*, § 3.52, and citations contained therein; *cf. Bowers v. New York & Albany Lighterage Co.*, 273 U.S. 346, 350 (1927); *United States v. Updike*, 281 U.S. 489, 496 (1930).

## CONCLUSION

For the foregoing reasons, petitioner respectfully requests that the Court reverse the decision of the United States Court of Appeals for the Fourth Circuit and reinstate the decision of the United States District Court for the Western District of North Carolina, which would result in the refund to petitioner of $1,618,306 of income tax, plus interest according to law.

Respectfully submitted,

ERIC R. FOX
*Counsel of Record*
ALAN J.J. SWIRSKI
IVINS, PHILLIPS & BARKER
*Attorneys for Petitioner*
1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
(202) 393-7600